# COMPARISON VALUATION METHOD ONLY AS GOOD AS ITS INPUTS

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*Any valuation method requires appropriate inputs. Are properties selected for the comparison method actually comparable?*

## Valuers' use of the comparison method

The comparison method is the main approach used by New Zealand valuers to appraise the value and rent for commercial properties. Its relatively simple set-up and the representativeness of current market conditions are put forward as arguments for applying the method. On top of that, the fact that the method does not take into account trends and expected inflation seems to make it independent of economic forecasts. Not surprisingly, the last large survey of New Zealand valuers revealed that 94% of them recognise it as the best method. However at least 63% of these valuers only use the comparison method for the rental assessment process.

There is no doubt that the comparison method has its merits, but this approach is only as good as the inputs to it. In other words, if the properties selected for comparison are not actually very comparable with the property which is the subject of a rental assessment (called a target property for convenience), then the whole process may lead to miscalculated estimates. The success or failure depends on the definition of 'similar'.

There are a number of reasons why the selection of similar/comparable properties may be difficult:

- A valuer may operate in a town with a very low number of new leases per year so that overall the amount of available information is low

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- A valuer may have limited access to the information on recent leases, even though there may be a sufficient number of recent leases
- There may be disagreement between valuers on what similarity in terms of size, location, age, etc really means.

As part of a research project, I conducted a survey among 470 valuers with a specialisation in commercial and industrial property. The sample of valuers and survey respondents is free of bias toward any region of New Zealand. A few survey questions were designed to identify how valuers define similarity between properties in terms of those variables. Valuers' definitions were used to evaluate the quality of property selection for the comparison method as later described in this article. Readers interested in more information about the online survey should refer to the author's previous article published in the Autumn 2016 issue of *Property Professional*.

This article seeks to answer whether valuers can deliver what they believe to be the right selection of properties for the comparison method. Moreover, it suggests changes in the market set-up which could improve the quality and efficiency of valuers' work.

## Data

The above questions cannot be answered without access to rental assessment reports. My analysis is based on 34 rental reports prepared for seven properties over the 1995-2015 period. All those properties were located in the industrial part of Christchurch-Middleton and Sockburn and were owned by one entity. On average these commercial properties include 1551 sqm of warehouse space, 207 sqm of office/showroom space and 38 carparks.

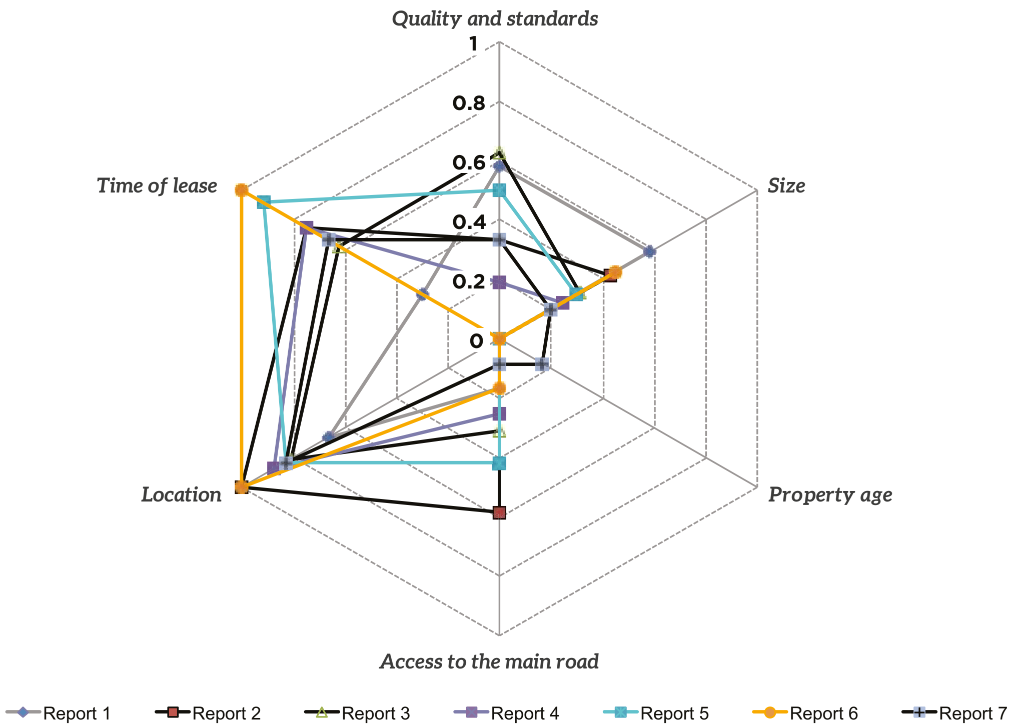
The number of reports per property varied between three and seven with a median and mean of 5.0 and 4.85, respectively. Almost all examined rental valuation reports applied only the comparison method. The number of selected properties varied between six and 17, with a mean of 10 and a median of eight. The reports were prepared by different valuers working for different companies, thus ensuring that their scrutiny was not biased towards any firm or valuer.

## Methodology

To define the comparability of properties, it is necessary to identify the key criteria characterising commercial real estate. To do this in an unbiased way, an online survey was conducted amongst 470 New Zealand commercial property valuers. Their contact details were manually extracted from the members' directory of the Property Institute. The response rate for the survey was 32.3%.

The survey revealed that New Zealand valuers recognised the following property-related characteristics as the most important criteria for selection of comparable properties in their rent assessment process: 1) location, 2) size of a property, 3) time of lease (period between date of the valuer's report and that date when

**Figure 1: Summary statistics for the similarity index estimated for seven rental assessment reports prepared for one property**




> *One of the interesting results obtained for the examined properties is that properties selected as input for the comparison method were either not matched in terms of age or age was ignored by valuers.*

a rental of the comparable property was established), 4) age of property, and 5) quality and standard of the property.

An access to a main road was mentioned, but recognised as less important. The survey also showed that valuers consider other factors such as economic condition, lease terms and incentives, and NBS rating. However these secondary criteria were not acknowledged by most of the respondents. There is also no information related to these criteria in the reviewed rent assessment reports. The results of the survey are summarised in **Table 1**, which shows how valuers define the similarity, semi-similarity and incomparability of two commercial properties.

**Figure 2: The arithmetic average of the similarity index for all seven properties**

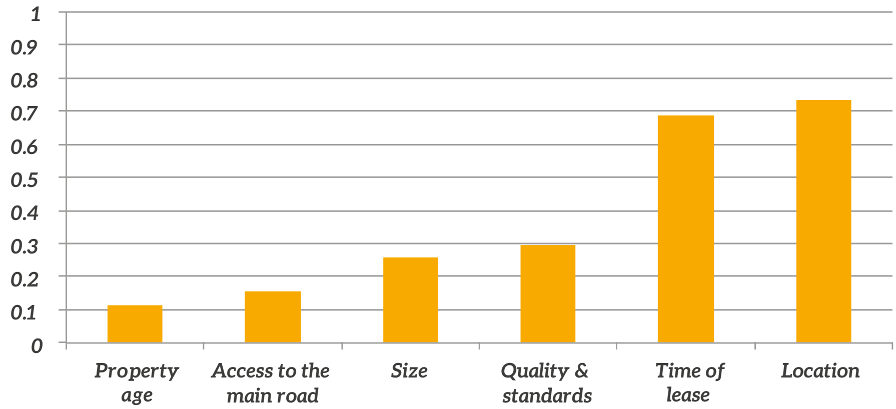



**Table 1: Definitions of comparability for New Zealand commercial properties**

| CRITERIA | SIMILARITY | SEMI-SIMILARITY | INCOMPARABILITY |
|---|---|---|---|
| **Time of lease** | The period between the date of the selected property's lease agreement for comparison and date of the target property's rental assessment is less than 12 months. | The period between the date of the selected property's lease agreement for comparison and date of the target property's rental assessment is more than 12 months but less than 24 months. | The period between the date of the selected property's lease agreement for comparison and date of the target property's rental assessment is more than 24 months. |
| **Location** | The distance between two properties is within a 2 km radius. | The distance between the two properties exceeds 2 km but is less than 5 km. | The distance between the two properties exceeds 5 km. |
| **Size** | The difference between the target property and selected property does not differ more than 20%. | The difference between the target property and selected property for comparison does differ more than 20% but less than 50%. | The difference between the target property and selected property for comparison differs more than 50%. |
| **Access to the main road** | Both properties have the same access. In other words if both properties are located on main road or back street (a 0–1 variable). | Both properties have the same access (a 0–1 variable). | Both properties have a different access (a 0–1 variable). |
| **Property age** | The difference in the age of the main building of the target and selected property for comparison is less than 20 years. | The difference in the age of the main building of the target and selected property for comparison is more than 20 years but less than 30 years. | The difference in the age of the main building of the target and selected property for comparison is more than 30 years. |
| **Quality and standards** | The selected and the target properties have nearly the same standard and quality. | There is some similarity in terms of standards. | The quality and standards of the selected property for comparison is very different or if the quality and standards of the selected property for comparison is not mentioned in the rental assessment report. |

**Table 2: Summary statistics for the property similarity index estimated for 34 rental assessment reports**

| | MEAN | MEDIAN | MINIMUM | MAXIMUM | RANGE |
|---|---|---|---|---|---|
| **Time of lease** | 0.35 | 0.35 | 0.35 | 0.35 | 0.35 |
| **Location** | 0.75 | 0.79 | 0.16 | 1.00 | 0.84 |
| **Size** | 0.26 | 0.26 | 0.12 | 0.45 | 0.33 |
| **Access to the main road** | 0.18 | 0.17 | 0.14 | 0.58 | 0.44 |
| **Age** | 0.70 | 0.71 | 0.19 | 1.00 | 0.81 |
| **Quality and standards** | 0.35 | 0.76 | 0 | 0.72 | 0.72 |

The above definitions of the comparability of two properties are expressed in different units, and are a combination of quantitative and qualitative measures. To make them comparable, a similarity index was devised to express the same units independently for the different categories (size, location, etc). The index includes six categories: size, location, time of lease, age of property, access to the main road and quality of the property.
The similarity index has a value of:

- 1 – if the selected and the target property are matched in terms of the above categories
- 0.5 – if they are sufficiently comparable
- 0 – if the selected property differs too much from the target property
- 0 – if there is not enough information on the selected property.

The similarity index is calculated for the whole report for each category (size, location, age, etc), averaged across all the selected properties in a given report. The reports with a score close to 1 indicate that a valuer's selected properties as input for the comparison method are matched with the target property that is the subject of the rental assessment process. On the other hand, a score close to 0 indicates that a selection is very poor and that the application of the comparable method will almost certainly lead to a misleading estimate of an appropriate rent.

## Results

To evaluate the quality of valuers' property selection as input for the comparison method, the above described similar index methodology was applied to all seven properties. **Figure 1** (page 32) presents the mean of the similarity index for each category across seven rental assessment reports prepared between 1995 and 2015 for one property only. The figure is a spider graph – the larger the web, the better the quality of a report. The analysis of reports shows that in categories such as location and time of lease the similarity index is close to 1. Thus in the case of the examined target property, valuers on average select properties in close enough proximity and which had recent rent established.

On the other hand, in the case of categories such as property size and its quality and standards, the performance is below median (less than 0.5) for all reviewed reports. It means that the valuers of the reviewed reports, despite their intention, were unable to select properties that are similar for those two criteria. One of the interesting results obtained for the examined properties is that properties selected as input for the comparison method were either not matched in terms of age or age was ignored by valuers (the value of the similarity index is close to 0).

To sum up, the analysis of rental assessment reports prepared for one property shows that in four out of six categories selected properties were far from a good match with the characteristics of the target property.

**Table 2** and **Figure 2** (previous page) show that the similarity index for all seven properties with 34 rental assessment reports are much in line with those reported above. That is, a good selection of properties in terms of location and recent rent was established, but a rather poor selection in terms of size and attention to quality and standard. As with the first property, valuers do not pay much attention to a main road or back street location or property age.

The results of analysed rent assessment reports confirm that valuers of the reviewed reports were not able to select comparable properties in line with the common agreed definition of comparability, with the exception of good performance in the selection of properties with a similar location and date of lease. Their poor performance is mostly related to property size and attention to property quality and standards.

Not surprisingly, when the surveyed valuers were asked if comparable properties in rent assessment reports prepared by the tenant's valuer versus comparable properties in reports prepared by the landlord's valuer are the same, a 50% or less overlap was reported by 87% of the surveyed participants. The lack of overlap may be at least partially explained by a lack of uniform information on recent leases available to valuers, and so their information is limited to their past valuations or valuations available in their company.

As a result, they have to use as input for the comparable method properties not matched with the target property. It may also be due to the fact that valuers are engaged in client advocacy. A few of the respondents in the survey stated that some valuers sometimes act as advocates for their clients – either the tenant or the landlord.

## Concluding remarks

The analysis of 34 rental assessment reports prepared for seven properties over a 20-year time span revealed that in some key property characteristics, such as size and property age and quality and standard, New Zealand valuers struggled to find matched properties. As a result, considering not-comparable properties as input into the comparison method may lead to an incorrect rent estimation.

The lack of sufficient information or the size of the market in which valuers operate are at least partially responsible for the current situation. I believe that the introduction of a comprehensive database including detailed information about rents for recent leases and renewed leases may improve the quality of valuers' performance. The benefits of such a database are two-fold. First, the database would bring more transparency and reduce the level of disputes amongst valuers representing tenants and landlords. Second, its introduction could reduce the problem of client advocacy, which is recognised by valuers as one of the challenges facing the profession.